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**International
Economic & Energy Weekly**

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24 October 1986

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**International
Economic & Energy Weekly**

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Synopsis

1

**Perspective—London's "Big Bang": Implications for International
Financial Markets**

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The financial deregulation in the United Kingdom scheduled for 27 October—referred to as the Big Bang—is only the latest step in the unprecedented restructuring of the world's financial markets. Although the Big Bang will internationalize the United Kingdom's previously insulated domestic financial markets, the deregulation will be more sweeping than similar US actions taken in the mid-1970s and its impact will extend well beyond London.

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United Kingdom: Bracing for the "Big Bang"

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The British financial sector is facing sweeping liberalization aimed at increasing its efficiency and keeping it competitive with the New York and Tokyo capital markets. We think the move to deregulation will strengthen British financial markets, but US and Japanese companies will probably dominate these markets.

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IMF and World Bank: Changing Roles

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The unexpected resignation of Jacques de Larosiere raises new speculation about the Fund's future role in the management of the LDC debt crisis. Even with the World Bank assuming a greater role, however, Bank-Fund coordination and greater Bank emphasis on debtor policy-based lending is likely to result in continued focus on structural reform—albeit medium term—in return for enhanced funding to debtor countries.

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South Korea: Semiconductor Firms Eye US Market

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Three of South Korea's major business groups are moving ahead aggressively with plans to develop an advanced microelectronics industry that will largely target the US market. Although the obstacles are formidable, the Korean firms have a number of advantages including a proven ability to acquire US technology and relatively low labor costs.

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South Korean Textiles: Industry in Transition

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We expect textiles to remain South Korea's major export over the next few years, but the industry faces tough challenges from new agreements limiting textile exports to the United States and Western Europe, and from low-cost producers such as China.

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Perspective***London's "Big Bang": Implications for International Financial Markets***

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The financial deregulation in the United Kingdom scheduled for 27 October—referred to as the Big Bang—is only the latest step in the unprecedented restructuring of the world's financial markets that is lowering barriers to the international flow of capital. Although the Big Bang will internationalize the United Kingdom's previously insulated domestic financial markets, the deregulation will be more sweeping than similar US actions taken in the mid-1970s and its impact will extend well beyond London. Experts agree that no major financial center has ever been shaken to the extent of the Big Bang and, because of the resulting boost in London's global financial stature, international financial firms are competing fiercely to establish a foothold.

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A competitive shakeout of financial firms in London following deregulation appears inevitable. Financial experts expect US firms—with their experience and reputation for flexibility and innovation—to emerge as world leaders. Big Bang deregulation will provide US and Japanese financial firms with many new opportunities. The elimination of barriers between the banking and securities industries will allow US and Japanese commercial banks in London to trade securities, which they are prohibited from doing in their own countries. Some experts believe this will serve as a trial for possible similar deregulation by the United States. Japanese firms, backed by their massive capital bases, will be able to underprice many competitors. While they will maintain a presence on the world scene, European firms—primarily British and West German—will be overshadowed by the US and Japanese financial giants.

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Following deregulation, London—already the world's top foreign exchange and Eurobond trading center—will also be in a position to capture global trading in other nontraditional financial instruments. The overhaul of London's market information system, coupled with its location at the center of the world's time zones, make it a natural hub for the emerging 24-hour global financial market. This gives London an edge over the world's two other principal money centers, eroding New York's position and keeping Tokyo a distant third. Europe's second-tier money centers are also likely to be adversely affected by London's strengthened position. According to US Embassy reporting, European brokers for the most part expect their home exchanges to lose business to London; we believe Frankfurt, Paris, and Zurich will fare reasonably well, while Milan and Madrid appear most vulnerable. At a minimum, these smaller exchanges will be forced to reassess their own regulatory framework to remain competitive.

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On the basis of the US experience with more limited financial deregulation, the Big Bang will probably thin the ranks of international financial firms in the London market over time. The survivors will substantially boost their global competitiveness, and thus the world's financial transactions are likely to be increasingly concentrated in a handful of large international firms that will dominate financial markets into the next century. Countries that seek to buck this trend toward globalization by maintaining or tightening regulation will risk hurting the global competitiveness of their domestic financial institutions. Such concentration, however, will create new vulnerabilities for the international financial system—financial troubles for one of these large firms could destabilize the entire system—increasing the need for supranational financial regulation.

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United Kingdom: Bracing for the "Big Bang"

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The British financial sector is facing sweeping liberalization aimed at increasing its efficiency and keeping it competitive with the New York and Tokyo capital markets. The changes in the way the City of London¹ does business will culminate in the so-called Big Bang on 27 October, with attention centering on the end of fixed commissions on stock transactions. We think the move to deregulation will strengthen British financial markets, but US and Japanese companies will probably dominate these markets.

The Move Toward Liberalization

The catalyst for the Big Bang comes from a 1978 legal action that the British Government brought against the London Stock Exchange for allegedly monopolistic behavior. Realizing legal proceedings would be protracted and costly—and, in the end, a losing cause—the exchange eventually reached an out-of-court settlement with the Thatcher government in 1983. The government agreed to drop its antimonopoly suit in return for the City's agreement for far-reaching deregulation of its practices by 1986.

Even without this court action, we believe several interrelated factors made liberalization inevitable if London was to remain competitive with other financial centers:

- Wall Street's abolition of fixed commissions in 1975 enabled US securities firms to undercut their British counterparts on large transactions.
- The abolition of foreign exchange controls by the Tories in 1979—although it helped London become the center of the Eurobond market—enabled many large institutions to purchase British securities in the United States.

¹ Britain's equivalent of Wall Street, the "City" is the financial district of London.

British Financial Sector

Although it has lost some ground in recent years, the City of London still ranks in the top three of world financial centers along with New York and Tokyo. The City has been the center of the Eurocurrency market since the 1960s with deposits totaling \$775 billion in 1985. A recent survey by the Bank of England showed the City dominates foreign exchange trading, handling an average of \$90 billion a day—\$40 billion more than New York. London also is the world leader in insurance and reinsurance, shipping contracts, and trading in many commodities. A financial futures exchange is presently undergoing rapid growth and could challenge for world leadership.

The City makes a significant contribution to the British economy and has experienced rapid growth since the abolition of exchange controls in 1979. Its foreign exchange earnings have risen nearly fourfold since 1979 and totaled more than \$10 billion last year. Overall, the financial sector accounts for about 7 percent of British GNP and is the main reason for the rapidly increasing role of services in the British economy. The sector accounts for about 10 percent of total employment—2 million jobs—up from 6 percent in 1975.

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- New technology has internationalized the world's capital markets by linking the major trading centers and allowing 24-hour trading.
 - US and Japanese competitors are better capitalized and offer more financial services than do London's traditional old securities firms. According to some estimates, until last year the combined capital of all London Exchange firms was less than that of Merrill Lynch.

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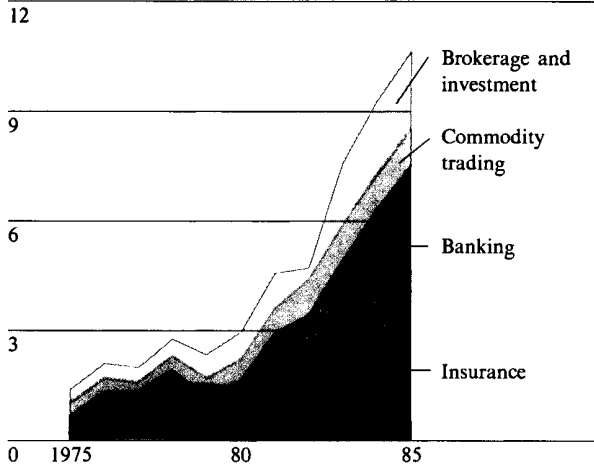
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United Kingdom: Overseas Earnings of Financial Institutions, 1975-85

Billion US \$



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Changes in British Markets

The Big Bang on 27 October will usher in the most sweeping liberalization of a financial market this century. The changes—most of which were initiated by the City itself—will dwarf those made by Wall Street in the 1970s and will substantially alter the way the City conducts business. []

Negotiated Commissions. The most important aspect of the Big Bang is the abolition of fixed commissions on the trading of stocks. The lack of negotiated commissions has not only impeded competition among British financial firms, but also has made them increasingly uncompetitive internationally. For example, the lowest commission currently available is 0.3 percent—for large transactions—while on Wall Street commissions for institutional traders run as low as 0.15 percent. Many money managers expect UK commissions to fall by about 30 percent after the Big Bang. []

Dual Capacity. Another important change is that securities firms will now be able to perform both brokerage and jobbing activities. Under the current single-capacity system—unique to London—some firms employ jobbers—individuals who actually buy and sell securities, making a profit on the spread between the purchase and sale prices; other firms employ brokers—who buy and sell securities for their clients from jobbers and make a profit on commissions. To encourage competition, brokers will be allowed to conduct transactions with their firm's jobbers only if the jobbers' sale price at least matches the lowest price on the market. Moreover, jobbers must now list their prices on the Exchange's electronic listing. []

Gilt Market Trading. A third key change is that the Bank of England will end the restricted trading on the gilts market, where British government securities are traded. At present, one company, Mullins, acts as the government's broker while two jobbing firms dominate the market. The Bank of England is setting up its own issuing group and 27 firms plan to deal in gilts—market analysts expect mergers and some outright failures to reduce this number because of the relatively small size of the market. The Bank of England is also contemplating selling gilts by the auction-style approach used by the US Treasury. []

Additional Changes. In preparation for the Big Bang, the London Stock Exchange has made several changes in its rules to encourage financial groups outside of the City to become members. As of 1 March 1986, the Exchange began allowing foreign firms to become members. In addition, firms outside the City can now own up to 100 percent of member firms, whereas the previous limit was 29.9 percent. On 29 April, the government announced the creation of a sterling-denominated commercial paper market that will allow firms to raise funds directly from lenders, as an alternative to going through commercial banks. To protect investors, the government restricts this activity to large companies listed on the London Stock Exchange and having net assets of at least \$75 million. British financial analysts believe this new market will attract firms that now go abroad—especially to the

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Regulating the City

The post-Big Bang regulatory environment is not yet set, but apparently will continue to stress self-regulation while formalizing the role of government as a watchdog. Under the present system, the financial markets police themselves with only informal government supervision. The new framework contained in the Financial Services Bill now being hotly debated in Parliament will vest day-to-day regulatory power in the Securities and Investments Board (SIB)—composed of market participants appointed by the government and ultimately responsible to the Department of Trade and Industry. The bill is partly modeled after US regulations although the SIB will not have the enforcement powers of the Securities and Exchange Commission, in particular the SEC's prosecuting authority. Other self-regulatory organizations, such as the London Stock Exchange, will be overseen by the SIB, and their regulations must be at least as stringent as those of the SIB. In order to conduct business in British financial markets, participants will be required to obtain permission from either the SIB or one of these organizations. The new legislation will not affect the Lloyds Insurance Market, which is covered by other legislation, or the banking markets, which the Bank of England will continue to supervise.

Thatcher's approach to policing the City as set forth in the Financial Services Bill appears to satisfy few people in the City or Parliament. Both Conservative and Labor MP's agree that increased supervision is necessary to maintain the City's integrity, especially in the wake of the Lloyds insurance scandal in the late 1970s and the questions about the collapse of Johnson Matthey Bankers last year. The Conservatives, however, want minimum regulation of the markets so as not to hamper the City's ability to attract business; they have rewritten many of the bill's provisions to accommodate the concerns of large financial firms. The Labor Party, on the other hand, is inherently distrustful of the City, and wants even tougher regulations. Though Laborites succeeded in increasing the powers of the SIB, they argue that self-regulation will not work even with greater disclosure rules and increased requirements to cooperate with the SIB. While the major changes brought about will remain in place, in all likelihood, there will be additional regulations in the future, especially if another scandal hits the City, or a Labor government takes office after the next election due by June 1988.

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United States—for short-term funds. They expect that 15-to-20 percent of British commercial borrowing will take place in this market within two years.

Implications

Overall, the Big Bang is likely to have a positive impact on the British financial sector and on the economy. London will strengthen its position as the center of Eurobond trading, and we expect the City to attract new capital and to recapture much of the business it has lost overseas in recent years. In the end, the changes should boost London's international financial stature and cement its place as one of the three most important financial centers along with New York and Tokyo.

While the longer term outlook is bright for the City of London as a whole, individual firms will face a severe shakeout as they adjust to a more open and competitive environment, and the likelihood of a scandal will increase as institutions scramble for business. US and Japanese financial giants have acquired stakes in British firms and opened their own City offices in anticipation of the Big Bang. Only eight of the top 20 brokerage firms operating in the City remain in British hands, and the merger and acquisition mania that has swept the City probably will continue for some time. US firms, experienced in operating in a competitive and highly innovative market, are likely to dominate the City when the dust settles, and Japanese firms will have a strong presence as well. As

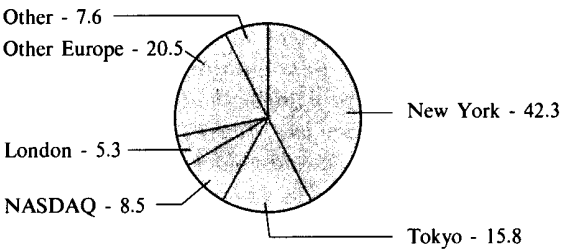
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**World Stock Exchange Trading Volumes,
1984**

Percent
Total = US \$1.8 trillion



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the Westland Helicopter and British Leyland affairs demonstrated, there is a danger of backlash if foreigners are seen as dominating what had been a uniquely British market. This could force even a Tory government to take some action to ensure that the City of London retains a distinctly British flavor.

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IMF and World Bank: Changing Roles

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The unexpected resignation of Jacques de Larosiere, the managing director of the International Monetary Fund for the past eight years, raises new speculation about the Fund's future role in the management of the LDC debt crisis. The World Bank, also under new leadership, could move to center stage depending on the resolution of such key issues as voting power and the amount of the next capital increase. Even with the World Bank assuming a greater role, however, Bank-Fund coordination and greater Bank emphasis on debtor policy-based lending is likely to result in continued focus on structural reform—albeit medium term—in return for enhanced funding to debtor countries.

On the creditor side, the recently exhibited flexibility by the Fund in negotiations with Mexico probably will reduce the value of the IMF stamp of approval. The Mexican agreement linked \$600 million of additional Fund assistance to the price of oil and allowed considerable leeway in setting a target for Mexico's budget deficit. Without the tough policies traditionally prescribed as part of IMF-supported programs, bankers are likely to be even more reluctant to participate in financial packages for debtor countries and may increasingly ask for guarantees from creditor governments or the World Bank as an incentive to lend.

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IMF: Backing Away On Debt

The IMF's traditional role in managing the LDC debt crisis is diminishing. Debtors, and now some creditors, believe LDC financial difficulties are more deep-seated and protracted than the temporary balance-of-payments problems that the Fund's austerity programs are designed to correct. While, in the past, commercial and official creditors have been reluctant to reschedule debt or provide new funds if a country has not reached an agreement with the IMF, now—of the big debtors—only Mexico has a current IMF agreement:

- Brazil recently rescheduled long-term debts of \$15.5 billion. Brasilia has insisted it will not accept IMF participation in the renegotiation of the remainder of its \$105 billion debt.
- Colombia secured a \$1 billion loan from creditors without a formal IMF agreement, and recently announced that it will not renew its informal monitoring agreement with the Fund, which expires 31 October.
- Peru refuses to negotiate with the IMF. Lima owes the Fund over \$160 million, and has been declared ineligible to receive additional IMF resources.

Mounting Arrears

In addition to losing some of its influence in managing debt problems, the Fund's ability to make financial resources available for use by member countries also is being eroded by the problem of mounting payment arrears. Overdue obligations to the Fund have ballooned from about \$95 million in June 1984 to about \$975 million in June 1986, with \$490 million now overdue by six months or more. This sharp upward trend probably will continue—countries currently in arrears have additional payments totaling about \$1.2 billion falling due in 1987, which they probably will be unable to meet.

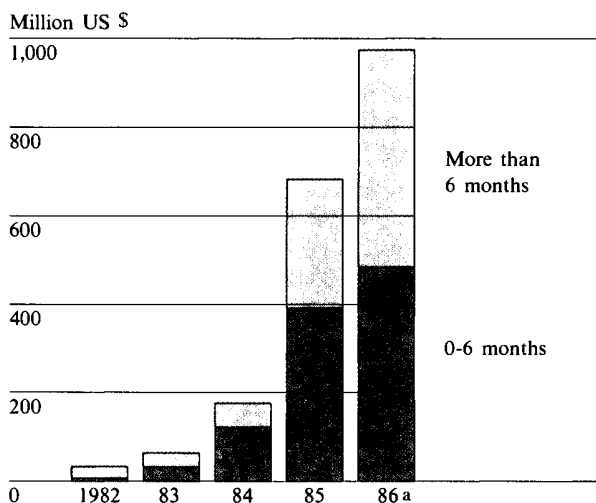
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While there is little immediate threat to IMF resources—uncommitted, usable resources currently amount to about \$30 billion—we foresee increasingly negative long-term effects on the Fund's financial position. Fund officials are worried that arrears will begin to impact on their ability to borrow from official creditors on similar terms and conditions as in the past. They are especially concerned because they need borrowed resources to finance the Fund's Enlarged Access Policy for debtors who have reached their

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Secret**Overdue Financial Obligations to the IMF, 1982-86^a**^a Data through June.

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will be reserved for Sub-Saharan Africa; India and China together will be allocated 30 percent, leaving 25 percent for all other IDA clients.

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Cofinancing and Guarantees. As it becomes a more active participant in the debt strategy, the World Bank is increasingly participating in commercial loans and offering guarantees to commercial creditors. In Chile, for example, the Bank guaranteed one-half of a \$300 million commercial cofinancing project in order to help Santiago put together an overall package of almost \$6 billion in reschedulings and more than \$1 billion in new money. In the Mexican rescue package, creditors won a Bank guarantee of \$500 million. In addition, the Bank's private-sector financing arm, the International Finance Corporation, has launched two programs in the past year that provide guarantees for equity investments. The Multilateral Investment Guarantee Agency (MIGA) will insure investors against noncommercial risks such as war, political unrest, currency nonconvertibility, and expropriation. A second program, called Guaranteed Recovery of Investment Principal (GRIP) will remove all risk of capital loss, a primary concern among US, Japanese, and European investors.

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borrowing limits under the Fund's regular programs. Because many LDCs have reached their quota limits, almost one-third of the Fund's loans to LDCs currently fall under this program.

World Bank: Filling the Gap?

As the IMF's role in managing the debt crisis diminishes, we believe the World Bank will be increasingly called on to fill the gap while continuing to meet the needs of its traditional constituents—the poorer LDCs.

Concessional Aid. As part of its traditional role, the Bank's members have agreed to a \$1.5 billion increase for the Bank's "soft loan" window, the International Development Association (IDA). As a result, the IDA, which channels low-interest, long-term loans to the poorest LDCs will be able to lend \$12 billion in the 1987-90 period. About 45 percent of the new funds

Changing Loan Policies

Since their introduction in 1980, structural adjustment loans (SALs) and sector adjustment loans—loans conditioned on policy or institutional reform—have become important vehicles for promoting sustainable economic growth in LDCs. In fiscal 1986,¹ policy-based loans amounted to \$3 billion or 19 percent of the Bank's total lending, up from 12 percent in FY 1985. In Mexico, for example, most of the Bank's \$1.9 billion contribution will be disbursed as sector loans to support trade liberalization, export development, and agricultural reform. At present, the Bank projects its policy-based lending will remain between 15 and 20 percent of total lending. We believe this is an attainable goal if, as the IMF continues to show flexibility in its dealings with

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¹ The World Bank's fiscal year is 1 July to 30 June

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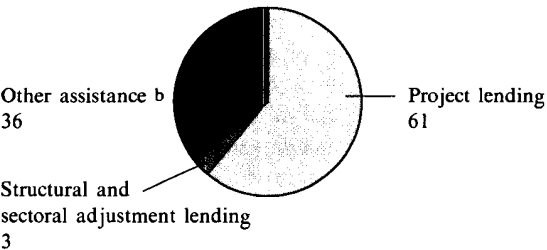
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World Bank Commitments by Lending Instrument, 1980 and 1986 ^a

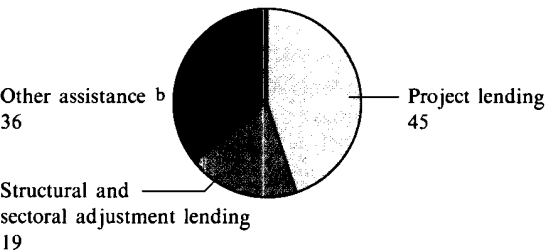
1980

Total = US \$11.5 billion



1986

Total = US \$16.3 billion



^a Fiscal period ends 30 June of the stated year.
^b Includes technical assistance, emergency reconstruction, and sector investment and maintenance.

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debtors, pressure for more fast-disbursing nonproject loans from the World Bank eases. If the IMF resumes its role as a tough negotiator, however, debtors may increasingly turn to the World Bank for help. Brazil and Colombia, for example, have obtained large sector loans from the World Bank but have refused to sign formal agreements with the Fund

Difficulties In Boosting Bank Capital

Even though the Bank has become more visible in the overall debt strategy, budgetary constraints in member countries and political squabbles over voting power could hamper increased participation. For example, the IDA replenishment negotiations were concluded only after months of political maneuvering on the part of the industrialized countries. Japan offered its \$2.5 billion contribution in exchange for a 1.6-percent increase in its Bank voting shares. Italy and the Netherlands also walked away with additional shares, but the exact size of the increase has not been worked out. To make these voting shares available, the United States agreed to release some of its 20 percent—which would have eliminated the US veto power in the World Bank—in return for Bank agreement to lower the veto threshold to 15 percent. This amendment, however, must be approved by the US Congress and the legislatures of other countries. Bank critics may push for other changes in Bank policy, while debtor governments, critical of continued US veto powers, may attempt to block the amendment altogether.

The political quarrels probably will erupt again when negotiations for a Bank General Capital Increase (GCI) get under way. An IBRD study suggests that if the Bank is to boost its nonconcessional lending to \$16-21.5 billion by 1990, as it projects, the member countries will have to approve the increase as early as 1987. The existing capital stock can support continued lending only at about \$14 billion per year.

The size of the GCI will be based on determinations of the desired future volume of lending, the share of fast-disbursing loans, repayment terms on future loans, and exchange rates. For example, an IBRD study suggests a GCI of \$37.5 billion will be needed to sustain annual lending at \$20 billion with 20 percent in policy-based loans. Other issues to be resolved include the amount of money that will actually be paid in, as opposed to simply committed by member governments, and the allocation of new voting shares. With voting shares based on the amount of the member's capital contribution, LDC voting power would be diluted; debtors are likely to push hard to preserve their voting strength.

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Role of the Regional Development Banks

Although the bulk of regional bank lending continues to be geared to project assistance, these banks may follow the World Bank's lead and institute policy-based lending:

The Asian Development Bank (AsDB)

- Loan commitments in FY 1985 totaled \$1.9 billion.
- The AsDB has concluded negotiations for a \$3.6 billion replenishment.
- The AsDB charter does not allow for policy-based lending. The Bank, however, will produce an economic strategy study for each of the 27 borrowing countries to try to influence, where necessary, their economic policies.
- The AsDB's recently established Private Sector Division signifies increased Bank emphasis on supporting private-sector development.

The African Development Bank (ADB)

- Loan commitments totaled \$1.2 billion in 1985.
- The ADB gives priority to projects that contribute to regional development and integration.
- The Bank recently initiated policy-based lending through cofinancing with the World Bank.
- Negotiations for a capital increase are likely to begin soon.

The Inter-American Development Bank (IDB)

- Loan commitments in FY 1985 totaled \$2.1 billion.
 - All loans are currently project loans entailing policy conditions only at the project level.
 - The IDB has discussed implementing quick-disbursing sectoral loans, but no decision has been reached; of the 15 major debtors, 10 are members of the IDB.
 - Negotiations for a \$250 billion capital increase are continuing. The most contentious issue is voting procedures for loan approvals—the United States is seeking a 65-percent majority requirement.
-

IMF/World Bank Collaboration

The debt crisis has blurred the distinct roles of IMF and World Bank operations. The Fund is now focusing more and more on medium-term structural adjustment, while the Bank, through its policy-based lending, is paying increasing attention to macroeconomic policy issues. To avoid the possibility of imposing conflicting policy conditions on a country, the Bank and Fund staffs assist each other in economic analysis and in the formulation of policy recommendations. We believe cooperation between the two will continue to increase as evidenced in the Mexican package. A major step in coordination was also taken in March, when the Bank and the Fund agreed to jointly administer a \$3.1 billion structural adjustment facility to support growth-oriented programs in Sub-Saharan Africa.

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Outlook

Debtor and creditor governments and commercial banks are increasingly looking to the World Bank as the new power broker in the debt strategy. We believe, however, that with more flexibility in its conditions, longer terms on its loans, resolution of the arrears problem, and more leadership in developing innovative fixes for problems, the Fund can continue to play an important role. It is unclear, however, what the ultimate role of the Bank in the debt problem will be. The Bank's ability to participate will depend on member support for a generous capital increase, passage of the veto amendment to ensure continued US support, and strong leadership from new President Barber Conable. We believe the Bank may also have to plan for larger increases in structural and sector adjustment lending if it hopes to convince commercial banks that it truly intends to act as an agent of economic reform in LDCs.

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South Korea: Semiconductor Firms Eye US Market

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Three of South Korea's major business groups are moving ahead aggressively with plans to develop an advanced microelectronics industry that will largely target the US market. The firms—backed by government support and armed with technical licensing agreements with US companies—poured about \$1 billion into their semiconductor operations during 1983-85 and project an additional \$1 billion on expenditures by 1988. Although they face formidable obstacles in entering a market dominated by established competitors, the Korean firms have a number of advantages including strong government and industry commitment, the financial muscle of the conglomerates, a proven ability to acquire US technology, state-of-the-art production facilities, and relatively low labor costs.

The Korean Strategy

Microelectronics is the centerpiece of South Korea's ambitious blueprint for creating a technologically advanced economy in the 1990s, and Seoul has made development of the semiconductor industry a key strategic goal. According to government projections, electronics, machinery, and autos will account for 39 percent of Korea's exports in 1991, compared with 22 percent in 1985. Under the 1983 semiconductor industry promotion plan and other programs, Seoul provides financing, tax relief, research support, and other incentives to the microelectronics industry. The monetary value of these benefits is not large, but they clearly signal the private sector that semiconductor development has high priority.

Responding to government incentives, three of the country's industrial giants—Samsung, Hyundai, and Goldstar—have embarked on an aggressive program to establish themselves as competitive producers of advanced microelectronics devices. The Korean companies are pursuing a "leapfrog" strategy in trying to

The terms
microelectronics and semiconductors are used interchangeably.

South Korea: Data on Key Microelectronics Firms

	Samsung	Hyundai	Goldstar
Investment, by yearend 1985 (million US \$)	450	300	200
Proposed investment, 1986-88 (million US \$)	680	125	290
Number of employees ^a	2,400	1,300	980
Processing capacity (wafers per year) ^b	1,164,00	650,400	608,200 ^c
Exports, 1984 (million US \$)	81	0	8

^a As of August 1985.

^b Does not include US wafer front-end facilities.

^c Includes 60,000 wafers per year pilot line at Anyang; could increase by 240,000 wafers per year if unconfirmed information about expansion plan is correct.

catch up with Japanese and US firms. Their approach seeks to shorten the learning time for producing standardized memory chips—primarily for use in computers and computer peripherals—by acquiring equipment, technology, and talent from abroad. They have signed numerous technical licensing agreements with US firms, and they have attracted large numbers of ethnic Korean engineers from US-based firms to fill key positions. Moreover, all three conglomerates have begun to accelerate their relatively modest R&D spending and have set up operations in Silicon Valley for development of new products.

South Korea's ability to quickly construct and equip production facilities—in about eight months, on average—and to tap US engineering talent and technology gave it a promising start in the advanced memory

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market. Samsung, for example, announced a prototype of the 64K DRAM chip in December 1983, just five months after entering the semiconductor business. Frustration has replaced the early optimism, however, because of difficulties in moving to production of more sophisticated devices. All three producers have experienced difficulties in improving yields on their 256K DRAM devices and have had recurring problems in their 1-megabit DRAM programs.

Where They Go From Here

South Korean firms are concentrating on improving yields of 256K DRAM devices this year. [redacted] To narrow the gap between themselves and Japanese producers, they want to produce samples of 1-megabit DRAMs by early 1987, but [redacted] it will be mid-1987 before production begins. Work also is beginning on a 4-megabit DRAM, which the Koreans hope to have in production by 1989. Earlier this year Seoul announced that development of the 4-megabit DRAM would be a joint effort of public, private, and academic researchers. [redacted]

Given the limited size of the domestic market relative to projected production capacity, we believe the United States—the predominant consumer of microelectronic devices—will be South Korea's largest export market for semiconductors. We estimate that less than 20 percent of South Korean chip production will be for domestic use and will largely reflect the needs of affiliated members of the conglomerates. [redacted]

[redacted] Moreover, even the chips used domestically will go into products such as VCRs, audio equipment, and televisions that are primarily destined for overseas markets, especially the United States. [redacted]

We expect the South Korean firms will use a variety of tactics to boost their overseas microelectronics sales. Low prices will almost certainly be the key to this marketing strategy. The firms are more interested in long-term market share gains than short-term

profits and have already shown a willingness to offer 64K DRAMs at prices below production costs. [redacted]

[redacted] The South Koreans may also use offset arrangements to encourage sales. [redacted]

[redacted] In addition, the South Korean firms may increase the use of arrangements whereby devices are designed in the United States and manufactured in Korea for sale to the US companies. [redacted]

Can They Get There?

The Obstacles. Breaking into the advanced end of the microelectronics industry probably presents the toughest challenge South Korea has faced since its rapid export-fueled growth began 25 years ago. In our view, the highly competitive and rapidly changing nature of the international semiconductor market—particularly for standardized memory chips—presents a particularly tough obstacle for the South Koreans. The market for memory devices is dominated by highly efficient Japanese producers. [redacted]

A lack of engineering talent probably is the most serious internal weakness facing the South Korean industry in its effort to catch up to the Japanese. Numerous observers point out that the South Korean industry has far too few engineers and technicians—and those it has are seriously short on experience—particularly with the wafer-manufacturing process. South Korean technicians frequently cannot detect fairly obvious equipment problems, and their lack of experience often results in machinery damage. [redacted]

In our judgment, a severe shortage of design capabilities—that is, the engineering skills to come up with new products and processes—will leave South Korea totally dependent on foreign designs for semiconductor devices for at least the next four or five years. As a result, South Korea will stay behind the learning

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curve on the latest technologies and be unable to match Japanese and US firms in introducing new products. Moreover, South Korea will be vulnerable to a cutoff in access to up-to-date foreign designs.

The South Korean industry faces several other problems that LDCs typically experience as they move into higher technology ventures, including deficiencies in quality control. Industry observers point to a tendency by South Korean executives to rush finished products "out the door," which sometimes results in the delivery of substandard chips. The South Koreans also suffer from an inadequate industrial infrastructure. Hyundai officials, for example, point out that they have lost thousands of wafers because of unannounced power outages at their Ichon facility.

The Strengths. Stacked against these obstacles and weaknesses are several factors that work in South Korea's favor:

- The South Korean conglomerates have massive financial resources to draw on. Hyundai, Samsung, and Goldstar are highly diversified business groups with annual sales of \$8-10 billion each.
- South Korea's low labor costs and lower costs for building facilities provide an important advantage.
- The South Korean plants are modern and are likely to remain equipped with the latest machinery.
- The South Koreans are addressing the talent shortfall by hiring ethnic Korean engineers from the United States, drawing on moonlighting Japanese engineers, and increasing domestic training—Korean engineering schools are turning out 23,000 graduates per year.

The Bottom Line. The strong commitment of government and business to development of a competitive domestic semiconductor industry and the financial muscle of the conglomerates suggest that South Korea is in the microelectronics industry for the long

term. The Korean firms have combined their semiconductor operations with profitable segments of their groups—such as telecommunications components—to cover their losses in semiconductors. We believe the South Korean companies will be particularly reluctant to abandon the microelectronics industry because of its critical role in the high technology industries they hope to master.

There are some factors beyond Seoul's control that will affect the Korean industry's ability to succeed. South Korean producers were hard hit by the dramatic decline in prices for 64K DRAM chips that occurred just as they were beginning to market their devices in early 1985. South Korean profitability will depend heavily on prices established by the large Japanese producers. The recent US-Japanese semiconductor agreement—which established a floor price for Japanese devices in the US market—should ease price competition and help South Korea gain market shares.

Implications

A strong microelectronics industry would be a plus for the South Korean economy in several respects. Semiconductor exports would directly strengthen the balance of payments and generate employment. Moreover, a solid production base in semiconductor devices would bolster the competitiveness of industries such as consumer electronics, computers, telecommunications, and autos, and could strengthen Korea's defense industry efforts. Failure in sophisticated semiconductors, on the other hand, would entail substantial financial losses for key business groups, set back Seoul's broader plans for moving up the technology ladder, and possibly undermine the influential position now enjoyed by a liberal-minded cast of economic planners.

Aggressive entry into the US semiconductor market—particularly through a low-price strategy—has the potential for new trade frictions. On a positive note, US firms will benefit from royalty payments

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because most of the Korean chips will be made under US licenses. US equipment firms would also benefit from a robust market for their capital goods, particularly if they improve their after-sales servicing. In addition, cooperative ventures between US and South Korean firms could bolster US competitiveness vis-a-vis Japan, at least in the short term. [REDACTED]

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As South Korea increases its capabilities for producing sophisticated microelectronics products, the potential for sales of COCOM-controlled devices or technology to the Soviet Union and particularly to Eastern Europe will grow. Although Seoul's concern that such technology might find its way to North Korea will motivate the government to try to prevent such diversions—particularly if pressed by the United States—we believe South Korea's strong export orientation will make Seoul reluctant to allocate additional money and manpower to tighten weak control mechanisms. Moreover, if the industry is suffering from losses and excess capacity, the private sector may look the other way on such diversions. [REDACTED]

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South Korean Textiles: Industry in Transition

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We expect textiles to remain South Korea's major export over the next few years, but the industry faces tough challenges from new agreements limiting textile exports to the United States and Western Europe, and from low-cost producers such as China. Moreover, the industry's costs are likely to continue to rise faster than its productivity because of limited investment in the new technologies. The inevitable transition of the textile industry from economic growth leader to declining industry status could cause political problems for Seoul when this major employer of unskilled labor cannot continue to absorb large numbers of workers from Korea's growing population.

Textiles Still Dominate Exports . . .

The textile industry retains its first-place standing among all South Korean export industries, but its share of total South Korean exports has fallen—21 percent in 1985 compared with 40 percent in 1971. The slide began in the 1970s, when South Korea began to diversify its exports by emphasizing capital-intensive chemical and heavy industries, and has continued more recently as Seoul has turned to knowledge- and technology-intensive manufacturing. The composition of textile exports has also shifted as low- to mid-priced apparel and knitted goods—nearly 60 percent of exports in 1985—have displaced fibers and fabric, textile export mainstays during the early 1960s.

The United States is South Korea's biggest customer, taking 35 percent of its textile exports last year. Korean textiles have been particularly attractive to US consumers because of their low prices. Seoul's currency policy—the won is loosely tied to the dollar—helps keep Korean producers competitive in the US market vis-a-vis other major producers in Hong Kong, China, Taiwan, and Japan. Moreover, the won-dollar linkage and protectionist barriers in Japan and Europe have limited expansion of Korean textiles to non-US markets.

. . . But Are Slipping in Importance

Despite policies designed to diversify the economy away from light, labor-intensive business lines, and their decreasing share of exports, textiles remain South Korea's largest industrial sector. Textile's slice of overall manufacturing has declined, but at a slower rate than its share of exports because rapidly rising incomes have boosted domestic demand. Fibers, fabrics, and apparel accounted for about 15 percent of the value added in manufacturing in 1985, a loss of 3 percentage points since 1976.

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Textile production continues to lose its luster as a source for new jobs—a trend that hits hardest the young unskilled job seeker. In the past, this labor-intensive industry has drawn off much of the “youth bulge” in South Korea's rapidly growing labor force. As a result, Seoul must rely on rapid growth in newer, capital- and knowledge-intensive industries, as well as services activities, to take up the slack. According to IMF estimates, in the 1970s, when the textile industry was dominant, 60,000 jobs in manufacturing were created for every 1-percent increase in manufacturing output. The same output growth rate now yields just 40,000 new positions, suggesting South Korea must average 10-percent annual real growth in the manufacturing sector to accommodate the 400,000 new entrants to the job market each year.

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Seoul's efforts to encourage the textile industry to update technology for the improvement of quality and productivity have had little effect, and economic technocrats in Seoul are worried about the industry:

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- Textile profits are being squeezed by labor costs that are outpacing improvement in worker productivity. While not yet at a critical point, the pattern is similar to the disastrous one in the late 1970s, before the severe “correction” in wages brought on by the 1980 economic slowdown and the Chun government's efforts to wring inflation out of the economy.

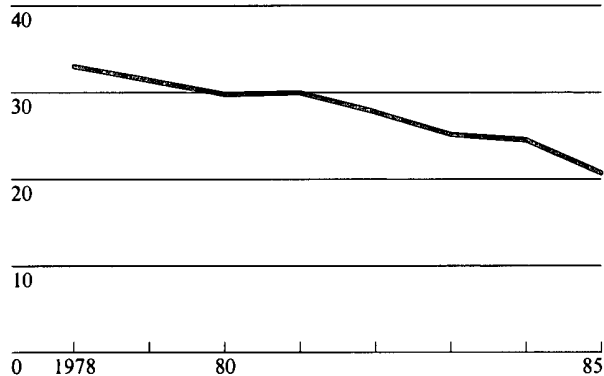
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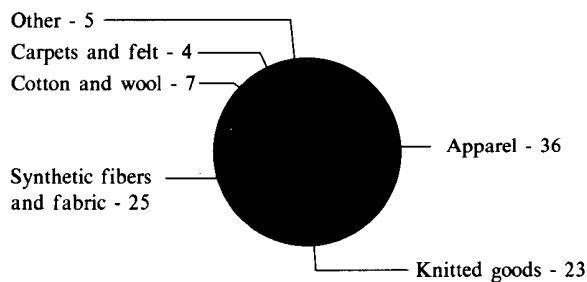
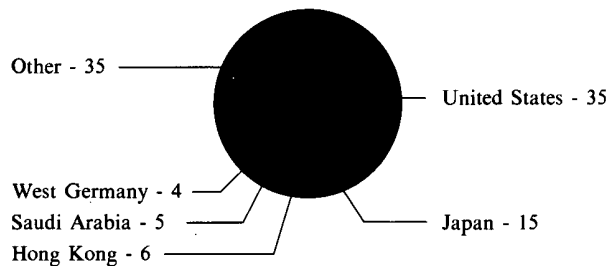
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Secret**South Korea: Textile Trade, 1978-85**

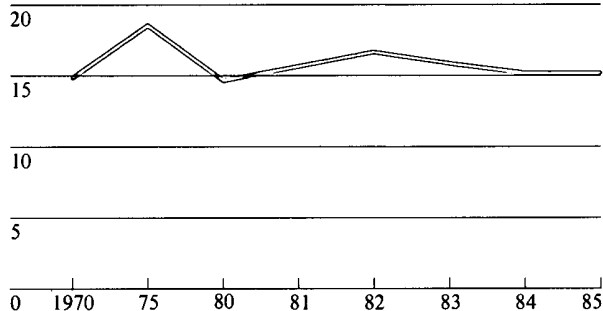
Percent

Share of Total Exports**Composition of Exports, 1985**

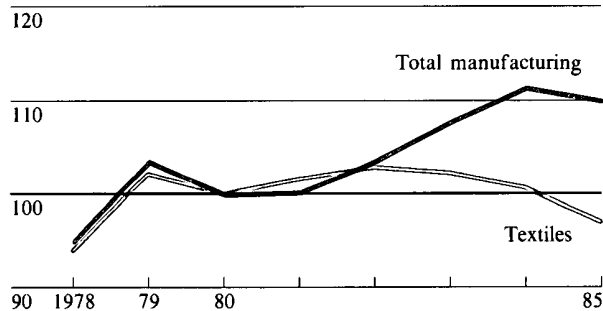
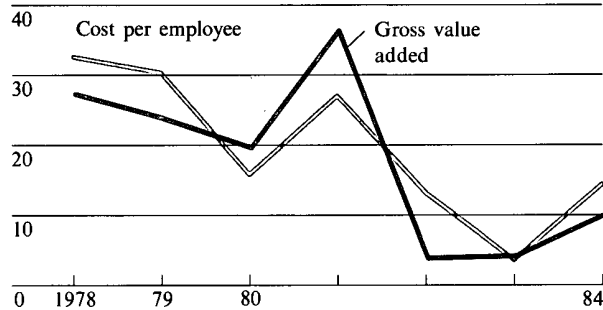
Total = US \$6.3 billion

**Export Markets, 1985****South Korea: Textile Industry, 1970-85**

Note scale change

Share of Value Added to Manufacturing Industry
Percent**Employment Trends**

Index: 1980 = 100

**Employee Cost and Productivity**
Percent

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- The profit squeeze has dissuaded textile firms from investing in new technology. Overall, the growth of the value of textile plant and equipment, adjusted for inflation, has been trending down, indicating that leading investors are shying away from textiles.

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Although South Korean textile workers have made solid wage gains and won improved on-the-job safety standards, they are falling behind their counterparts in other manufacturing sectors. Textile wages have risen nearly 8 percent in real terms since 1980 compared with the 9-percent real increase on the average for manufacturing as a whole:

- A profile of textile workers explains part of the gap. Many textile workers are women—66 percent compared with 33 percent for nontextile industries—who often quickly leave the textile work force for marriage or better jobs. As a result, management has shown little inclination to offer higher wages or to invest in better working conditions, particularly in small garment operations.
- Textile workers are among the least unionized in South Korea. They make up 26 percent of the manufacturing work force, but account for only 13 percent of the membership in the mostly government-dominated unions.

Hinterlands Hit Hardest

Textile producers have reacted bitterly to the recent bilateral accord that limits the growth of South Korea's textile exports to the United States to less than 1 percent per year until 1989. This restriction has aggravated political discontent in provincial manufacturing centers such as Teagu and Pusan where several industries are already in a slump, despite South Korea's generally booming economy. In Pusan, for instance, shipbuilding is sagging, and nearby defense-related industries are operating well below capacity. Moreover, regions heavily dependent on the textile industry for jobs tend to harbor smaller firms, which, as subcontractors for the dominant firms, feel the pain of falling orders most. Limits on textile exports could also create trouble for the government in what it views as a key constituency—the rural sector—because money sent home by textile workers is an important supplement to farm income.

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The Chun government's commitment to an import liberalization plan that pits foreign goods against domestically produced products in the local market also has fueled opposition in provincial industrial centers, which have benefited from domestic import restrictions. Antigovernment and anti-US protests in Seoul sparked by South Korea's concessions on trade issues have struck a responsive chord in regional capitals, and economic problems in these areas could fuel protests.

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Increased political problems in the provinces could further irritate a sore spot—the government's failure to curtail the flight of capital from the provinces to Seoul where bankers see a better return. The flow is aggravating an already severe shortage of loanable funds, thus restricting local development and job growth.

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Seoul's Plan To Bolster the Textile Industry

To begin to deal with the textile industry's emerging problems, Seoul has ordered the dissolution of 5 percent of South Korea's fabric companies and has banned new firms from entering the business. In addition, Seoul has increased loans to the textile industry to \$15 million in 1986, up from \$4 million in 1985. These funds are earmarked for improvement of facilities and replacement of aging equipment, rather than for expansion of production. The loans, which include a three-year grace period, are not a subsidy to the textile industry—their 8-percent interest charge is higher than LIBOR's 6-percent rate and Japan's 5-percent prime rate.

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In our judgment, Seoul's plan will not go far toward solving problems in the textile industry. The funds available are a small fraction of what the industry needs for a complete restructuring. The new plan, along with tough action to put troubled business groups on firmer financial footings, however, serves notice that the textile industry is an increasingly tempting target for a sweeping reorganization program under the government's direction.

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Secret**Outlook**

The close linkage of the won to the weak dollar and the underlying competitiveness of the textile industry—primarily its low-wage, highly motivated work force—will serve as a prop for the industry over the next year or two. South Korean textile manufacturers for the near term can continue to live off the fat of the large increases in exports they have recently enjoyed. According to press reports, textile factories are running at 97 percent of capacity, allowing cutbacks without harming efficiency. While South Korean textile producers remain among the most cost efficient in the world, this advantage is quickly eroding—the challenges from low-cost producers such as China will increasingly hurt Korean textile sales. []

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The US and EC agreements that sharply limit South Korean textile exports to these crucial markets cloud the longer term outlook. Significant reductions in exports would create problems for the government. We believe Seoul needs a healthy textile industry to act as a crucial employment bridge through the early 1990s to accommodate the youth bulge as it moves into the ranks of new job entrants. Knowledge- and technology-intensive jobs cannot pick up all the slack. If employment in textiles continues to decline, it could further complicate rural- and provincial-centered development plans that the government considers a key to continued political stability. []

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Briefs**Energy***Mixed Results in
China's Third-Quarter
Energy Production*

China's electric power sector scored an impressive 9.1-percent increase in production through September, and oil production rose 3.1 percent, according to the State Statistical Bureau; preliminary reporting indicates little or no growth in coal production. Last year's record additions to thermal power capacity have allowed China to boost power production—totaling 328 billion kilowatthours through the third quarter—more than offsetting drought-related losses in hydropower output. Oil production grew to 2.6 million b/d following the opening of a major new production area at the Shengli field. Coal production has been stagnant, however, as Beijing tries to draw down huge stockpiles. Between production and inventories, China should have sufficient coal both to meet domestic needs and to reach its 1986 export goal of 10 million metric tons—a 30-percent increase over last year.

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International Finance*Latin American
Debt Policies*

Members of the Latin American Economic System (SELA) called last week for linking payments on the region's \$370 billion foreign debt to export earnings or GDP growth. Meeting in Peru last Friday, delegates from the 25 member countries stressed the need for a political solution to the debt problem that recognized their "right to development," but neither specified a formula for reducing payments nor committed SELA members to any common course of action. The primary purpose of the meeting probably was to reinforce the signal that Latin debtors want debt reschedulings that allow cutbacks in payments if their economies weaken. Although the communique reflected a tougher debtor stance, it also reassured creditors that each country will continue to negotiate individually. We expect that Argentina, Brazil, and Venezuela—among others—will seek some type of payment limit, similar to that in the Mexican-IMF agreement. Almost certain resistance from lenders probably would provoke a stronger restatement of Latin goals at next month's Non-Aligned Movement conference on debt in Lima. []

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*Jamaican Pressure
on the IMF*

Prime Minister Seaga probably will use his threat to resign to pressure IMF officials in current standby negotiations. According to US Embassy reports, Seaga's recent threat to resign as party leader next month and as Prime Minister next August and his recent Cabinet shuffle have rallied support within the ruling party. Although opposition leader Manley stated recently that the government's last claim to legitimacy is its ability to produce an IMF accord, [] [] Manley will not press for an immediate election, hoping that Seaga's political and economic problems worsen. Besides consolidating support within his

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party, Seaga's threat to resign probably was intended to alarm US and IMF officials by holding out the specter of Manley's returning to power. The threat, nonetheless, gives Seaga the appearance of a lameduck whose political position would be undermined further without an IMF agreement soon. []

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*Vietnam Fails
To Renegotiate
Debt With IMF*

The IMF has turned down Hanoi's request to restore Vietnam's access to IMF credits suspended because of its failure to repay overdue financial obligations to the Fund. Hanoi repaid \$1 million of the country's \$63 million debt to the IMF in July and Vietnamese banking officials sought unsuccessfully to reschedule further repayments during the IMF's annual meeting earlier this month. []

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[] Hanoi also had sought IMF assistance in obtaining an estimated \$200 million in former South Vietnamese assets frozen in US banks, which could be used to repay its overdue debt. Vietnamese officials plan to return to Washington in January for further negotiations with the IMF, but we believe there is little prospect that Hanoi will be able to repay enough of its arrearages—some nearly three years overdue—to enable Fund officials to restore credit access. []

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International Trade

*South Korea
Seeking Increased
Regional Trade*

South Korea recently hosted a negotiating session aimed at expanding preferential trade arrangements with Southeast Asian LDCs, according to US Embassy sources. The agenda included reduction of tariff and nontariff barriers and enlisting new countries to be included in the agreements. Korean officials indicated that Thailand showed interest and Seoul probably will pursue trade agreements with Indonesia, Malaysia, and the Philippines. South Korea is searching for export markets outside the United States and Europe, and views the Pacific region as one of the most promising areas. The sharp appreciation of the yen against the won has dramatically increased South Korean trade competitiveness in Southeast Asian markets—traditionally dominated by Japan—and Seoul probably feels it can capture a significant part of Japan's export share. Seoul probably hopes such trade agreements will boost its image in Southeast Asia.

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*LDC Concessions
and the US GSP*

As part of the review of the US Generalized System of Preferences (GSP), Washington had requested improvements from a number of LDCs on their trade practices in order to retain duty-free status for their exports. US bilateral discussions focused on issues such as market access, intellectual property rights (copyright, trademark, and patent laws), investment, services, steel, and textiles. While the LDCs were reluctant to make concessions, reports now indicate substantial gains for the United States. For example, Hong Kong, Malaysia, South Korea, and Taiwan negotiated bilateral pacts on textile and apparel, while Brazil negotiated an agreement on steel exports to the United States. Some, such as South Korea, Thailand, and the Philippines, also made concessions on intellectual property rights. []

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Key LDCs: Issues and Products That Determine US GSP Eligibility

<ul style="list-style-type: none"> ○ Concessions granted ○ Concessions requested but not granted by LDCs 	Market access	Insurance	Trademark and patent	Copyright	Textile and apparel	Steel	Nontariff barriers	Investment and services	Subsidies
Taiwan	○	○	○	○	○	○	○	○	○
South Korea	○	○	○	○	○		○	○	○
Hong Kong	○				○				
Thailand	○		○	○	○		○		○
Brazil	○			○	○	○		○	○
India	○			○	○				
Indonesia	○		○	○					
Malaysia	○		○	○	○				
Mexico	○		○				○		
Singapore	○			○		○			○
Philippines	○		○	○	○		○	○	
Argentina	○		○				○		
Peru	○	○	○	○			○	○	○
Ecuador	○						○	○	

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Global and Regional Developments

Superfund Sparks Strong Reaction in Venezuela and Ecuador

The US decision to impose a tax on oil imports to raise revenues for environmental cleanup—Superfund—has generated alarm in Venezuela and Ecuador that it will be followed by more protectionism. Venezuelan President Luisinchi claimed that he had been misled by US statements and press reports that President Reagan would veto legislation calling for a tax on oil that discriminates against imports. In Ecuador, Foreign Ministry officials assailed the tax as inconsistent with the free trade philosophy espoused by the US administration. In both countries, government officials acknowledged that the tax will have little impact on their foreign exchange earnings, but expressed concern that the tax could open the door for a \$5 or \$10 per barrel tax at some future date. The Superfund controversy is likely to intensify Venezuelan efforts to diversify its export markets by investing in refining and distribution facilities in Western Europe. In addition, Venezuelans are likely to amplify their charges that Caracas's support for US policy in the Caribbean Basin goes unrewarded. In Ecuador, the leftist-controlled Congress is likely to add the US oil levy to its list of criticisms of President Febres-Cordero and his pro-US stance.

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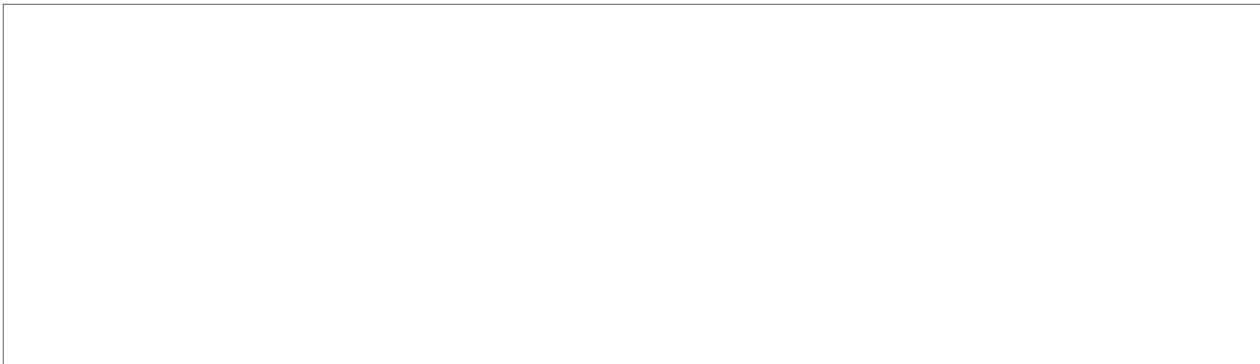
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Secret***Foreign Automotive
Manufacturers Invest
In Taiwan***

Taiwan's decision last year to open its auto industry to foreign joint ventures has attracted considerable interest. Thus far, six Japanese firms, France's Renault and Peugeot, and one US automaker have set up joint ventures. In addition, one Japanese and two other US auto manufacturers are eyeing possible deals. We believe that the Taiwanese auto firms recognize that their products lack the quality and technical sophistication to compete in the world market. Taiwan produced only 157,000 vehicles last year but had the capability to produce at least 300,000. We believe that the recent spate of joint ventures will result in the export of Taiwan-assembled cars, first to Canada and later to the United States—possibly beginning in 1988.

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National Developments***Developed Countries***

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***Japanese Highway
Project Holds
Potential for
Conflict With US***

Bidding for a \$7 billion highway and bridge across Tokyo Bay has the potential to become a major issue in US efforts to open Japanese construction projects to foreign participation. President Oka of the newly established Trans-Tokyo Bay Highway Corporation (TTBHC) has said he expects foreign construction companies to demand the right to bid on the project, but plans to observe how the Kansai International Airport Corporation (KIAC) deals with the issue of foreign participation in construction projects before deciding on a bidding policy. Since the 8 October KIAC-sponsored seminar that explained bidding practices for the airport construction, Washington has seen no further progress toward winning concessions for foreign involvement. In our view, Oka will find it difficult to maintain that the TTBHC is a private company that is free to ignore public-sector contract procedures because in March 1987 the Japan Highway Public Corporation (JHPC)—a Japanese Government agency—will become a partner. Moreover, the highway will belong to the JHPC, whereas Kansai Airport will remain under the control of the Kansai International Airport Corporation. The JHPC, unlike KIAC, is one of the government entities Tokyo agreed in July 1985 to place under the GATT government procurement code, obligating itself to open competitive bidding.

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*Japan Rethinks
Rice Price
Supports*

Japan's political leaders are seriously considering changes in the rice price support system that would lead to large reductions in the number of farmers and increase productivity of the agricultural sector. In a recent Upper House Budget Committee session, Prime Minister Nakasone blamed price supports for the high price—currently about six times the world market price—that Japanese consumers pay for rice. [REDACTED]

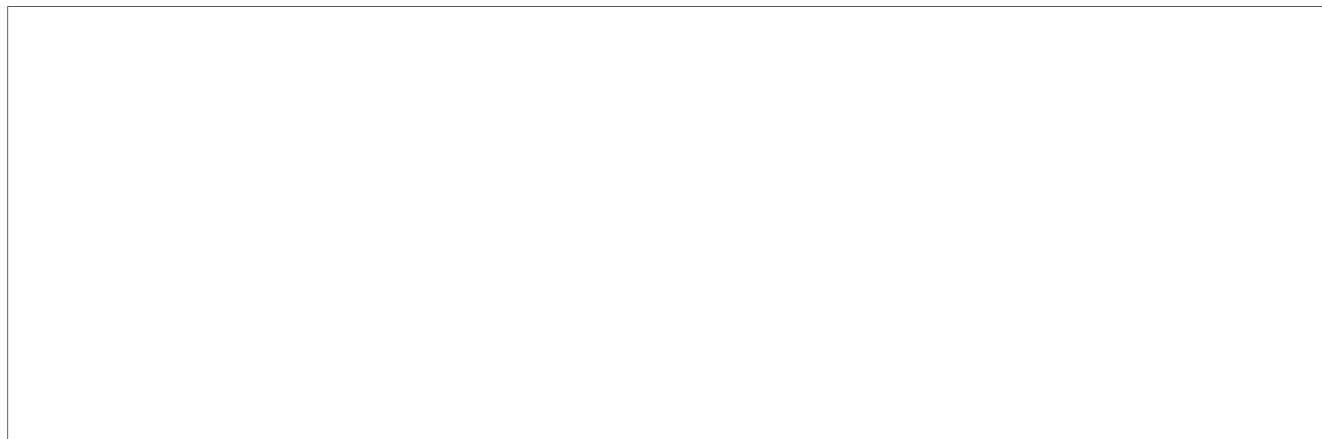
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[REDACTED] Nakasone may have been reacting to the reported plans of the opposition Japan Socialist and Democratic Socialist Parties to study the possibility of pushing for reform of the subsidy system to win urban consumers' support. Nakasone also may be trying to buy time on demands by US rice millers for market access by proposing a domestic initiative on Japan's agricultural policy. Any major overhaul would probably be based on a report being prepared by an advisory council to the Ministry of Agriculture that is expected to recommend that price levels be determined by the productivity of the most efficient farmers rather than the least efficient as is the case now. [REDACTED]

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*MITI Encourages
Basic and
Applied R&D*

MITI's new industrial restructuring legislation will probably contain a proposal to encourage business to increase spending for basic and applied research and development. MITI's new incentives, if passed by the Diet, will become part of the overall plan to enhance Japan's basic R&D infrastructure seen as critical to maintaining competitiveness in the future. The proposed funds—including subsidized loans and R&D tax credits—will assist businesses moving into new technology areas and those established to carry out basic and applied R&D. These business-oriented incentives will complement Tokyo's recent efforts to promote basic R&D at government and academic research facilities. [REDACTED]

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*West German
Opposition's
International
Economic Policy*

West Germany's Social Democrats support Washington's call for more expansionary policies from Bonn—an ironic contrast to the party's usual demand for greater independence from the United States. SPD economic spokesman Wolfgang Roth recently stated that a reduction in the US budget deficit—which the SPD considers a prerequisite for a reduction in the US trade deficit—would damage the

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world economy unless offset by European and Japanese expansion. Roth urged that Bonn play a leading role in this effort to demonstrate that West Germany takes its international responsibility seriously. He also argued that, in any case, expansionary measures are warranted for purely domestic reasons. Growth, though respectable in recent years, has been insufficient to reduce unemployment below the 2 million level. The SPD believes that both interest rate cuts and a reorientation of budgetary priorities to emphasize domestic investment are required. According to another SPD spokesman, interest rate cuts are also necessary to dampen US protectionist sentiment.

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*West German Monetary
Expansion Still
Exceeds Target*

West Germany's Central Bank money stock (CBM)—the key indicator of monetary policy—exceeded its official target range again in September. CBM growth so far this year is about 7.4 percent, compared with the 5.5-percent upper target; and for the year, will almost certainly overshoot the upper limit for the first time since monetary target ranges were established in 1979. West German financial officials continue to cite excessive monetary growth as the key factor in their refusal to cut the discount rate, arguing that a rate cut would increase liquidity, heighten the potential for inflation, and send the wrong signal to unions renegotiating wage contracts next year. Although we do not expect the Bundesbank to tighten monetary policy to meet this year's targets, the overshooting will complicate the setting of target ranges for 1987.

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*London Continues
To Resist Full
EMS Membership*

The British Government has indicated that it will not become a full member of the European Monetary System before the next election, despite increased pressure to join. Prime Minister Thatcher reiterated her opposition to joining the system's exchange rate mechanism after meeting on 20 October with West German Bundesbank President Poehl. The West Germans argue that participation would demonstrate Britain's "European credentials" and will help London stabilize the pound without raising interest rates. Thatcher also faces pressure within her government to bring sterling into the EMS: Chancellor of the Exchequer Lawson, Foreign Secretary Howe, and Bank of England Governor Leigh-Pemberton have all expressed support for joining. The Labor Party also recently dropped its opposition to membership provided the EC members undertake expansionary economic policies—a condition Bonn opposes. Thatcher remains opposed, however, because she prefers to keep monetary policy independent of West German actions and is concerned that membership would not eliminate the need to raise interest rates if the pound comes under pressure.

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*Norway's Labor
Government
Submits Budget*

The minority Labor government will probably compromise enough on the 1987 budget to prevent the opposition from uniting and bringing down the government. Despite the decline in energy tax revenues—from \$5.3 billion in 1985 to below \$3 billion in 1986 and even less in 1987—Labor wants to increase total spending by 10 percent to about \$33 billion. Labor also is asking for 3-percent real growth in defense spending—down from the 3.5 percent the previous Conservative-led government had planned—but use of an unrealistic inflation assumption makes it likely that more funds will have to be appropriated. The budget includes a variety of tax hikes designed to raise revenue and dampen consumer spending in an effort to control accelerating inflation and contain the current account deficit. Oslo also wants a controversial progressive tax on gross income to finance social security. To avert a concerted opposition attack on the government in the fall, Labor has sought to accommodate the Center and Christian People's parties' support of increased spending for social programs and rural areas, and has hinted it will compromise on the progressive tax proposal. Labor's apparent flexibility and the inability of the opposition parties to formulate an alternative budget will probably give the government a breathing spell. The opposition may prefer to let a budget pass in the hope that low oil prices will continue to disrupt the economy and further discredit Prime Minister Brundtland's leadership. []

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*New Israeli
Economic Measures*

Israeli officials have decided to clamp down on private borrowing to curb a surge in consumer credit and spending. The Bank of Israel intends to raise the interest rate on short-term loans by 4 percentage points over the next year, according to press reports. The US Embassy reports that the government also is moving to reform the capital market by making it easier for private companies to borrow much-needed investment funds. These measures will provide an early test of incoming Prime Minister Shamir's commitment to the economic programs inaugurated during Peres's tenure as Prime Minister. Shamir probably will try to continue the coalition government's economic stabilization program. Shamir realizes that Peres's policies were responsible for slashing inflation to an annual rate of about 20 percent, as compared with triple-digit inflation during the early 1980s when Likud last directed the economy. Easy credit has helped to spark the recent boom in private consumption—an expansion that runs counter to the government's attempt to contain imports and inflation. []

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Less Developed Countries

*Brazil's Fiscal Policy
Fueling Inflationary
Expectations*

Swelling inflationary pressures are undermining the success of the Cruzado Plan. In contrast to Brazil's rosy projections early this year that its deficit would drop to only 0.5 percent of GDP in 1986, [] it may exceed last year's 4.3 percent. Although tax collections are up, overall government revenues have not risen as much as hoped, largely because the Cruzado Plan's price freeze has prevented parastatals, particularly public utilities, from implementing much-needed rate hikes. Meanwhile, expenditures are rising, as the Sarney government boosts spending on social welfare projections and transfer payments. Subsidy payments also are up because of a bumper wheat harvest and the recent milk

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subsidy, according to the US Embassy. Businessmen cite government reluctance to curb spending as a major cause of their expectations that inflation will rise next year, according to Embassy and press reporting. To restore private-sector confidence, the government will need to move quickly after the Congressional election next month to reduce the deficit. [] Brasilia is considering an administrative reform package—including personnel reductions and privatization of some state-owned enterprises. Based on past experience, however, we believe reform efforts will be gradual, and that Brasilia will continue to concentrate on raising revenues rather than decreasing expenditures.

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*New Mexican
Wage Hike*

A government commission has announced an unprecedented third hike in minimum wages for this year, raising the cumulative wage increase to nearly 100 percent. Mexico's largest trade union is backing legislation that calls for even more frequent wage increases. If it passes as expected, workers, employers, and government representatives could negotiate minimum wage hikes as often as once each month. Although real wages will fall again this year, the de la Madrid government probably hopes the promise of more frequent wage boosts next year will keep labor leaders in line. Monthly wage increases would exacerbate inflation, already expected to double to at least 115 percent this year. This would increase the prospect of wage and price freezes next year, although officials appear reluctant to try to implement measures similar to those in Argentina and Brazil. In any event, Mexico City is likely to postpone implementation of controls at least until the next scheduled negotiation of wage increases in January. []

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*Tanzanian
Foot-Dragging on
Economic Reform*

President Mwinyi's failure to follow through on promised reforms is beginning to erode support for his year-old leadership. The government has still not implemented an IMF-recommended economic recovery plan, and, [] the much-publicized anticorruption campaign has stalled despite evidence against many officials. Earlier this month university students boycotted classes to protest corruption and the government's economic bungling. Mwinyi's inactivity probably reflects in part continuing opposition of the party chairman and former President Nyerere, who rejects the IMF reform program and sees the anticorruption campaign as a vendetta against his followers. The economically hard-pressed government, however, can ill afford to allow this impasse to jeopardize the hard-won IMF agreement and accompanying bilateral aid pledges. Mwinyi's indecision may also cost him the loyalty of senior ministers and intelligence and military personnel who have investigated government corruption. []

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*Philippine Financial
Rescue Package
Moves Forward*

IMF approval of a \$500 million balance-of-payments loan for the Philippines—expected today—will pave the way for a \$10-billion financial rescue package. According to US Embassy reporting, the IMF's program is designed to generate economic growth of 6 percent annually over the next four years, in part by permitting the government to stimulate the economy with public spending this year. Manila, in turn, pledges to make economic reforms that will reduce adverse

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government intervention in the economy and establish a more competitive and export-oriented business environment. The Fund's approval will trigger a \$300 million World Bank loan, \$350 million in new credits from foreign banks, and lead to rescheduling nearly \$8 billion in payments due over the next five years on Manila's \$26 billion foreign debt. In addition, according to US Embassy reporting, Manila has requested that the IMF and foreign banks consider up to \$1 billion in contingency financing if import costs rise or exports slump unexpectedly. Despite lower interest rates, stable prices, and relatively abundant foreign exchange, Manila's economic team is almost certainly worried that the economy will fall short of the 1.5-percent growth target this year. Moreover, lagging government spending may hold growth to only 4 percent next year. Manila is counting on a resurgence in private investor confidence next year to sustain the economy's recovery, however. To help achieve this goal, Manila reportedly is seeking over \$400 million in US economic assistance, up to \$840 million from Japan, and a total of nearly \$100 million from West Germany, Canada, Australia, and the EC to finance investments as well as demonstrate confidence in the Aquino government.

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*Bankers Expect
Malaysia To
Devalue Currency*

[redacted] bankers believe that Malaysia will devalue its currency by 10-to-25 percent during the next few months because pressure on the ringgit is forcing Kuala Lumpur to intervene almost daily to stabilize the currency. [redacted] the ringgit's drop is a result of the economy's sharp decline—real GDP, which fell by 1 percent in 1985, will show little or no improvement in 1986. A devaluation of this magnitude would probably relieve pressure on the ringgit and reduce capital flight, which some international banks estimate exceeds \$2 billion annually and is increasing. It would also probably forestall a rescheduling of Malaysia's more than \$20 billion external debt, which we believe is increasingly likely in the next two years unless the economy rebounds sharply. Nonetheless, devaluation will not help commodity exports—which account for over 60 percent of total exports—unless demand abroad strengthens.

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*Indonesian Concerns
About Stability*

Jakarta, increasingly concerned that Indonesia's deteriorating economy will lead to unrest, is showing little finesse in restoring public confidence or in handling criticism of its economic policies. The government last week closed the second-largest newspaper and warned several others that speculative and critical economic reporting threatened national stability. [redacted]

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[redacted] the US Embassy reports that there was little economic rationale behind last month's 31-percent devaluation. Advocates of the devaluation apparently believed that its longer term benefits would enable the government to enter the 1987 elections on an economic upswing but underestimated the adverse near-term impact on inflation and unemployment.

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Secret***Communist******Sino-Soviet
S&T Cooperation***

Representatives of the Soviet and Chinese State Committees for Science and Technology last week signed a protocol specifying fields for S&T cooperation under a general agreement signed in December 1984. Scientists from the two countries will reportedly work together on agriculture, fisheries, meteorology, nonferrous metallurgy, petrochemicals, machine building, oil and natural gas, and railways. The protocol made no mention of joint research in two areas proposed by the Soviets earlier this year—space sciences and seismology—indicating Chinese rejection. The protocol is one of a growing number of bilateral technical cooperation agreements. Last June, for example, the Chinese and Soviet Academies of Science agreed to undertake joint research; a year earlier, Beijing and Moscow signed an accord on industrial technological cooperation. Nonetheless, the countries have had difficulty reaching agreement on areas for cooperation, and we believe Beijing remains wary of Soviet assistance as well as skeptical about its value—given China's access to generally more advanced Western scientific research and industrial technology. [REDACTED]

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***Efforts To Slow
Chinese Economy
Taking Effect***

Industrial output increased at about a 6-percent annual rate through September, reflecting Beijing's continued success in moderating growth after an excessive 18-percent jump last year. Figures released recently by the State Statistical Bureau show that the slowdown has been at the expense of consumer durables; the output of industrial and construction materials, such as steel and concrete, has changed little. The new data also show inflation running at about 5 percent this year, down from 9 percent in 1985. Last year, domestic opponents sharply criticized China's reform leaders for allowing overly rapid growth that strained energy supplies and transportation, and lowered production efficiency and quality. Beijing reacted by restricting credit and ordering a slowdown in capital construction—up only 10 percent so far this year, as compared with a 40-percent increase in the first nine months of 1985. More stable economic performance is one of the main reasons reformers have been able to implement new economic experiments this year and—if inflation continues to slow—Beijing may proceed with price reforms that were put on hold a year ago. [REDACTED]

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***China Announces
New Foreign
Investment Incentives***

Last week, Beijing announced long-promised incentives for joint ventures, aimed at reversing a 20-percent decline in overseas investment commitments during the first half of this year. The new guidelines apply primarily to enterprises that produce mainly for export or that introduce advanced technology. Special preferences include tax reductions, lower and more uniform rents, exemption from import license requirements for essential inputs, and some exemptions from state wage subsidies. The guidelines also reaffirm Beijing's commitment to management reform, guaranteeing the enterprises autonomy over production, wages, bonuses, and personnel—including the hiring and firing of workers and senior management. The new guidelines, however, offer little relief on repatriating foreign exchange, one of the key concerns for foreign investors. While most foreign investors will

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adopt a wait-and-see attitude toward the new regulations, according to the US Embassy, these measures are a step in the right direction to improve the deteriorating investment climate. The high-level attention afforded these changes, moreover, suggests significant pressure will be applied at the grassroots level to encourage successful implementation. [REDACTED]

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*Vietnam
Planning for
Oil Exports*

Hanoi is apparently confident that Vietnam will soon produce commercial quantities of petroleum. [REDACTED]

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Although we cannot yet confirm whether Vietnam will be able to produce the projected volume of crude oil, US firms discovered oil offshore South Vietnam in 1974, and since 1981 the Soviet Union has been helping Vietnam with exploration and drilling in the same area. [REDACTED]

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